SEED CAPITAL reVIEW

SEMI-ANNUAL REPORT | FIRST HALF, 2014

PUBLISHED BY: MEMBERS OF THE ENTREPRENEURIAL SERVICES GROUP AT GRAY PLANT MOOTY

GRAY PLANT MOOTY

Welcome to the second edition of Seed Capital reVIEW, written by members of the Entrepreneurial Services Group at Gray Plant Mooty. As with our prior report, this version analyzes seed and angel capital financings by early-stage companies in Minnesota (typically financings of between $100,000 and $2 million).

In this edition of Seed Capital reVIEW, we summarize the survey responses we received regarding financing transactions completed during the first six months of 2014. Our first edition of this report, published earlier this year, summarized similar data covering the last six months of 2013.

In addition to analyzing the specific data of the financings closed during the first half of 2014, we were also able to compare that data to the responses we received for the second half of 2013 in this survey. While it is only the second such report, in each case with a sample size limited to active respondents, we are attempting to identify some trends in the terms of seed and angel capital financings. We hope this will be useful to reviewers of this report as they structure future financings. Over time, as we conduct more surveys and accumulate more data, we anticipate that these trends will become more apparent and more useful to our readers.

As with our prior survey, we are very grateful to have received such a terrific response regarding financings during the first six months of 2014. We received responses from individuals and companies involved in 84 separate financings. Having such a robust response helps us to provide a realistic lens on the terms on which seed and angel capital financings are being consummated in Minnesota.

In late January, we plan to circulate our survey for deals in the second half of 2014 and expect to publish our next Seed Capital reVIEW next spring. In the meantime, we hope this information is useful to you and helps facilitate more successful seed and angel capital raising transactions for Minnesota's emerging growth businesses.

Thank you for your continued support of the Seed Capital reVIEW.

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EXECUTIVE SUMMARY

For this second edition of the Seed Capital reVIEW, we analyzed survey responses from 84 separate financings, the majority of which were provided by individual angel investors or angel groups.

Some key metrics and findings for the first half of 2014 were:

- The survey's sample encompassed a broad range of industries, with particular concentrations in the medical/healthcare, technology and cleantech/biotechnology industries.
- A significant majority of the deals utilized the Minnesota Angel Tax Credit.
- As with our prior survey, pre-revenue companies comprised slightly less than half of the total financings.
- Approximately 72% of respondents reported offerings structured using equity securities (and 68% of those were common equity, with the remainder being preferred equity), with debt securities comprising the remainder.
- The most frequent rights received by equity investors were:
  - Participation rights in future investment rounds.
  - Over 80% of investors in preferred equity reported some form of liquidation preference, with all respondents receiving a 1x liquidation preference.
  - One board seat or observation rights.
- For debt-structured offerings:
  - Almost all respondents reported debt with an initial term equal to or greater than 1 year.
  - A majority of respondents reported receiving rights to participate in future financings.
  - Almost 70% of debt-structured offerings were convertible to company equity.

About the Firm

Gray Plant Mooty is the oldest continuing law practice in Minneapolis. With more than 160 attorneys, and additional offices in St. Cloud and Washington, DC, the firm's uncompromising client service and practical legal advice have earned it the trust of clients around the world.

About the Entrepreneurial Services Group

The Entrepreneurial Services Group at Gray Plant Mooty brings together legal expertise and business acumen that entrepreneurs can depend upon at every stage of their emerging or growth business. The group builds a deep, personalized understanding of each client's needs, and its attorneys develop legal solutions that help best accomplish their clients' long-term goals. By moving as quickly as its clients do, the group provides responsive service that mitigates the present and potential challenges facing any new business.

Before delving into the specific details of the survey results, we think a few overall comments may help with your review.

In general, the results of this survey were consistent with the results that we received from our prior survey. For example, as with our prior survey, the most frequently represented industries were the medical/healthcare and technology sectors. As was noted in our prior survey, the medical/healthcare space continues to be quite active in Minnesota, and was the largest single industry reflected in this survey. Technology companies, especially software, were a close second. We have noticed a significant increase in the last few years in the prevalence of early stage software companies in the Twin Cities, and believe this trend will only continue to grow. With events like MinneBar, Startup Weekend, the Minnesota Cup and many other similar events, the environment for starting a high tech startup in the Twin Cities has improved over the last few years.

In addition, our survey results continue to support the notion that pre-revenue companies can raise capital in Minnesota, although it's easier to raise capital for post-revenue companies. The survey results also continue to reflect that the use of placement agents or brokers is not prevalent in early stage capital raising transactions, and the use of general solicitation under Rule 506(c) has not yet become a popular device for raising capital. Further, the terms on which equity and debt securities were raised (considering pre-money valuation and frequency of certain "preferred-like" features (e.g., board seats, preemptive rights, liquidation preferences, and antidilution protection) and other key terms) were similar to what was reported during the prior survey period.

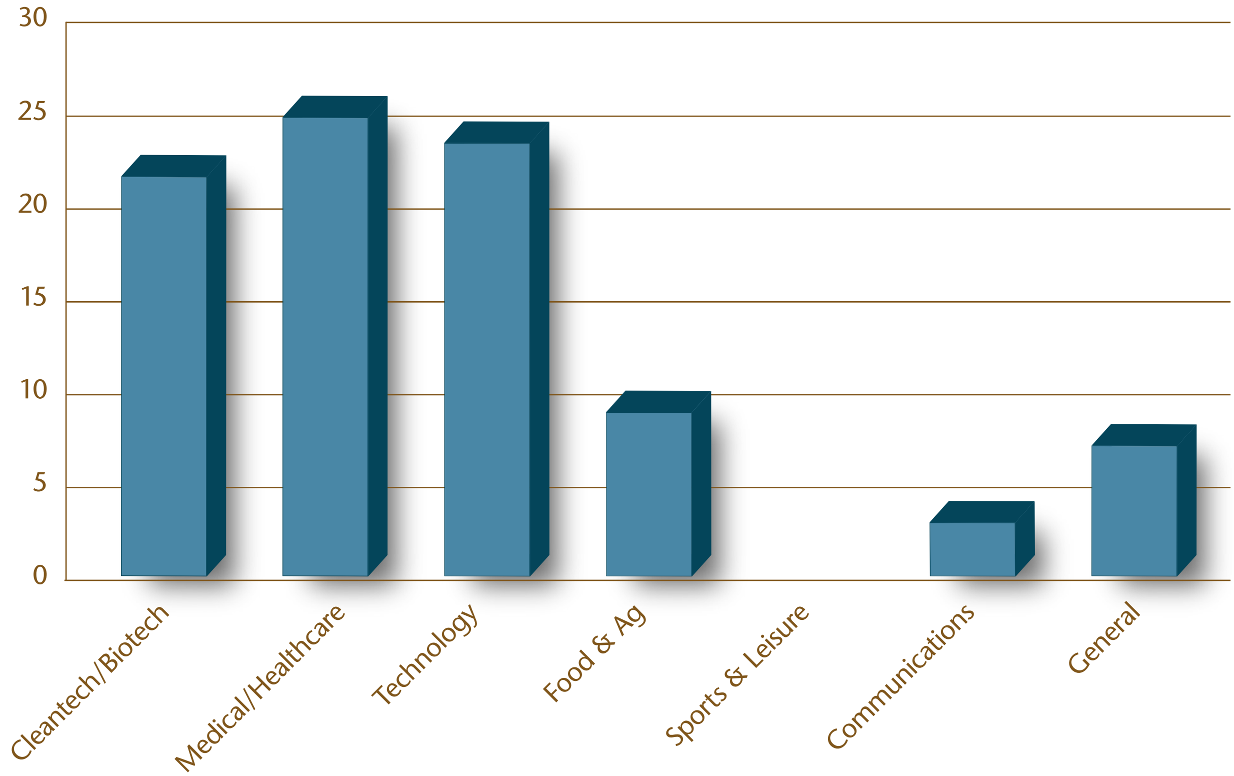
It is also apparent among respondents of this survey that the Minnesota Angel Tax Credit continues to be an important consideration in the success of capital raising transactions. Indeed, 80% of respondents reported that the Minnesota Angel Tax Credit was either crucial or important to the success of their offering.

CHARACTERISTICS OF COMPANIES RAISING EARLY-STAGE CAPITAL

Industry

As was the case with the prior survey, the two most frequent industries identified for having raised capital during the first half of 2014 were medical/healthcare (28%) and technology (26%). Interestingly though, 24% of respondents identified their company as being in the cleantech/biotechnology industries. This is a substantial increase over the prior survey, where only 15% of respondents identified as being in the cleantech/biotechnology industries. It is not clear whether this increase is just impacted by a still limited survey size, or whether this is the beginning of a larger trend of increased investment in the cleantech/biotechnology industries. We will continue to examine this category in future surveys.

Respondents noted the following with respect to the industry of the companies raising capital:



Pre- or Post-Revenue?

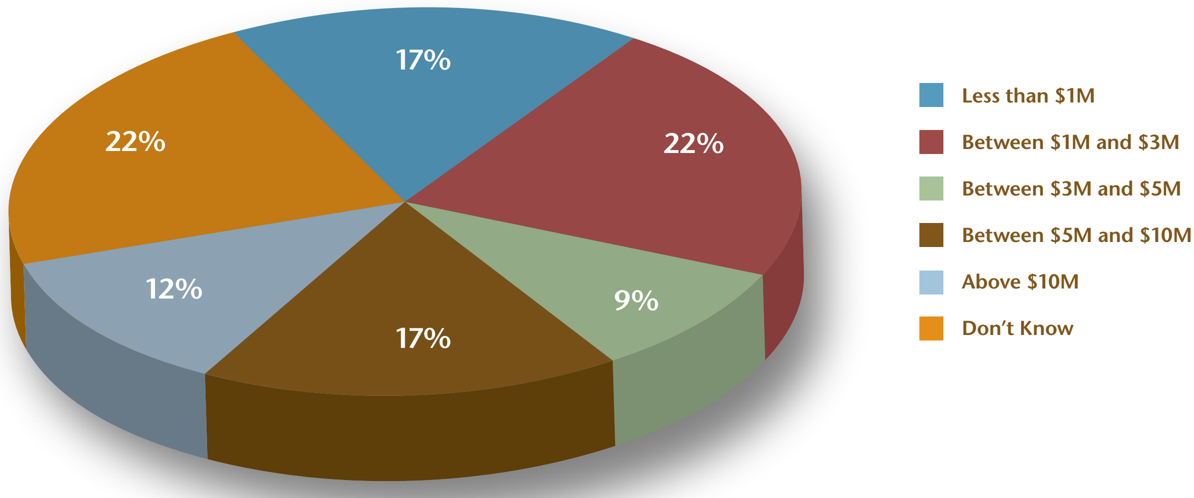
Approximately 43% of survey respondents indicated that they have not yet generated revenues, with the remaining 57% indicating that they have already generated revenues. This is similar to the results of the prior survey, when 47% of survey respondents indicated that they were pre-revenue, with 53% identifying as being post-revenue.

As we looked at the data a little closer, we noticed that nearly 45% of pre-revenue companies in the survey were in the medical/healthcare space, and of those, nearly 85% were medical device companies (with the remaining 15% in the healthcare IT space). This should not be surprising, as medical device companies have several regulatory hurdles to clear before they can begin selling products and generating revenue. In fact, more medical device companies in this survey were pre-revenue than were post-revenue.

For all other industry categories, more of the respondents indicated that they were post-revenue than pre-revenue, although not by significant majorities. This would seem to indicate that while having revenues is an obvious benefit for a business, and it is helpful in persuading investors that the business plan works, it is not necessarily a prerequisite to attracting investor capital.

Pre-Money Valuation

We received 58 responses to the question regarding pre-money valuation, approximately as follows:



Because respondents to our prior survey most frequently identified a pre-money valuation of $5 million or greater (21%), we added the "above $10 million" category to this survey. As you can see, in the current survey, over 29% of respondents identified their pre-money valuation as being $5 million or more, a slight uptick over the prior survey.

Almost identical to the prior survey (22%), the highest single response to this question, at just over 22%, was a pre-money valuation of between $1 million and $3 million.

The survey results for this question were similar to the results from our last survey, except that more companies in this survey (17%) identified as having a pre-money valuation of less than $1 million (only 9% in our prior survey). As noted above, more respondents (29%) identified having a pre-money valuation in excess of $5 million than was the case for our prior survey (21%).

Finally, we note that only 5% of respondents indicated that the price for this offering was less than their prior offering (i.e., a "down round"). The remainder indicated that the price was higher (43%), flat (29%), or that they didn't know (23%).

While it is positive that only 5% of respondents noted down round pricing, we're not sure that we can glean any larger analysis from that response yet. Pricing in early-stage capital financings is very company-specific and can be based on a number of factors that aren't addressed by this survey. Nevertheless, we'll continue to track this category and determine whether any discernable trends emerge.

BROKERS AND GENERAL SOLICITATION

Use of Placement Agents or Brokers

There was a slight increase in the percentage of offerings that reportedly involved the use of a placement agent or broker. For the first half of 2014, 16% of offerings reported the use of a placement agent or broker, whereas only 10% of offerings in the second half of 2013 reported the use of a placement agent or broker. Even with the slight uptick, the vast majority of offerings still did not involve a placement agent or broker, which is consistent with our experience in seed and angel offerings.

Use of General Solicitation under Rule 506(c)

We are continuing to track the use of Rule 506(c) of the Securities Act of 1933 in early stage offerings. For those who do not already know, Rule 506(c), which was finalized just over a year ago, permits issuers to use general solicitation as part of an offering, provided that all investors in the offering are accredited and that the issuer "takes reasonable steps" to verify that all investors are accredited.

Only 10% of offerings in the first half of 2014 reported the use of general solicitation under Rule 506(c). This is down from the second half of 2013, when nearly 20% of offerings reported the use of general solicitation under Rule 506(c). We thought the 20% number in the prior survey was likely anomalous (particularly since the rule was enacted last fall and would have only been available for the last two months of the survey period). While closer to our direct experience, even having 10% of respondents for the first half of 2014 report using general solicitation under Rule 506(c) was still above our expectation. We will continue to monitor this particular question closely for future surveys to determine whether the use of general solicitation under Rule 506(c) gains traction as a viable way for early stage companies to raise capital.

EQUITY V. DEBT

Of the respondents to our survey, approximately 72% identified the securities in the offering as being equity securities, while the remaining 28% identified the securities as debt securities. This is similar to our prior survey, when approximately 68% identified the securities as being equity securities, with the remaining 32% identified as debt securities.

Characteristics of Equity Securities

Similar to our prior survey, more than twice as many respondents indicated that the equity securities sold were common equity as opposed to preferred equity.

Of those identified as involving equity securities, the respondents reported receiving the following “preferred-like” features:

Right to participate in future rounds of financing:	50%
One board seat:	19%
Observation rights:	19%
Anti-dilution protection (weighted average):	7%
Registration rights:	4%
Anti-dilution protection (full-ratchet):	4%
Warrant coverage:	4%
More than one board seat:	4%
Redemption right:	0%
None:	31%

The percentage of respondents indicating that they received one board seat (prior survey result was 3%), observation rights (prior survey result was 9%) and/or rights to participate in future rounds of financing (prior survey result was 33%) were up fairly substantially relative to the prior survey. This may reflect a trend in these preferred-like rights in equity financings, or it may just be an anomaly based on the limited sample size. As the survey develops over time, we’ll watch these results carefully, as these terms are often heavily negotiated.

Liquidation preference

Of the reported preferred equity financings, nearly 80% reported receiving some form of liquidation preference, versus 85% in the prior survey.

Interestingly, of those reporting a liquidation preference, all were 1x the invested amount, with nobody reporting a greater amount. No respondents reported receiving a liquidation preference in excess of 1x the liquidation amount. In the prior survey, 30% of respondents reporting a liquidation preference noted that the preference was more than 1x the liquidation amount. That result may just reflect the particular companies and investors that responded to this question, although this is consistent with the trend we have witnessed in seed and angel deals toward less lucrative liquidation preferences.

We should also highlight that approximately 60% of the respondents who reported receiving a liquidation preference noted that the preference was participating (the other 40% reported that the preference was non- participating). This is slightly up over the prior survey, when the divide between participating and non-participating financings was evenly split.

There is a relationship between having a lower fixed liquidation preference and a participating right. That is, investors may be more willing to accept a lower liquidation preference if the preference is participating. If the preference is non-participating, the investors are more likely to demand a higher liquidation preference.

From the company’s perspective, it is important to do an analysis of potential exit scenarios (using a couple different models, such as best case, worst case, and likely case), to determine the impact of how the structure of various liquidation preferences would affect the outcomes to other shareholders. Only then can the company make an informed decision about the likely implication of a particular liquidation preference.

Characteristics of Debt Securities

For those who indicated that the investment was structured as a debt security, board representation (one seat) or observation rights, rights to participate in future rounds of financing, anti-dilution protection (weighted average), and preferred dividends were the most common types of preferred-rights granted to investors/lenders. The detail on "preferred-like" features relating to debt is as follows:

Right to participate in future rounds of financing:	57%
Anti-dilution protection (weighted average):	21%
One board seat:	21%
Observation rights:	21%
Preferred dividends:	21%
Anti-dilution protection (full-ratchet):	14%
Registration rights:	7%
Redemption right:	7%
More than one board seat:	0%
None:	7%

Unlike with equity offerings, the "preferred-like" features accorded investors in debt offerings in this survey was down (almost across the board) relative to the prior survey. Significantly, only 21% of respondents reported receiving one board seat (whereas 57% of respondents reported receiving one board seat in the prior survey) and observation rights (whereas 36% of respondents reported receiving observation rights in the prior survey). We'll continue to monitor trends relating to this question, as these features are heavily negotiated between investors and companies.

Interest Rate

The results to the interest rate question were similar to our prior survey. 20% of debt respondents reported that the interest rate on their debt security was less than 5%; 67% of respondents reported that the interest rate was between 5% and 10%; and 13% of respondents reported that the interest rate was greater than 10%. The only real deviation from the prior survey responses was this latter category, as no respondents from the prior survey reported receiving an interest rate in excess of 10%.

Security Interest in Assets

53% of respondents involved in a debt financing reported that repayment of the debt was secured by the company's assets, while the remaining 47% reported that the debt was unsecured. The percentage of financings with secured debt was up from the 40% reported by respondents in the prior survey.

Warrant Coverage

67% of respondents involved in a debt financing reported receiving no warrant coverage at all, which was almost identical to the prior survey's 65% response. 7% reported receiving between 10% to 20% warrant coverage with 27% reporting receiving more than 20% warrant coverage. These numbers are also consistent with the prior survey.

Term of the Debt

Regarding the term of the debt (that is, the duration of the company's obligation to repay the debt), 73% of the respondents reported debt that had an initial term of more than 1 year. Only 7% reported that the debt had a maturity of less than 1 year, and another 20% reported that the debt had a maturity of exactly 1 year. These results were also consistent with those of the prior survey.

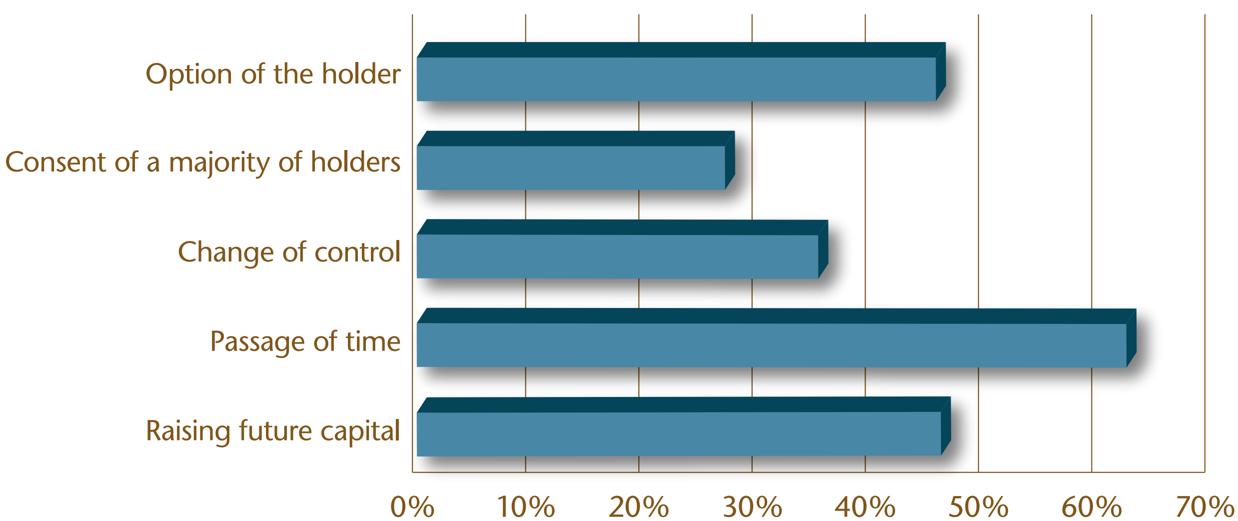
Convertible Debt

Almost 70% reported that their debt is convertible into equity, with the remainder being not convertible. This is similar to the prior survey, where 75% of respondents reported receiving convertible debt. Given that much of this seed stage debt financing has the risk profile of equity, it isn't surprising (or different from our experience) that most investors will want the ability to convert into equity, thereby securing the right to an equity return on their investment.

As noted in our prior survey, for a debt offering to qualify for the Minnesota Angel Tax Credit, the debt must mandatorily convert into equity (and it cannot convert into equity within the first 180 days following its issuance).

Of those who received convertible debt, somewhat surprisingly, only 40% reported that the debt converts into the next round at a discount to the next round's price (60% of respondents to the prior survey noted that the debt converted into the next round at a discount). The reported discounts ranged between 20% and 30% of the offering price in the next round. These ranges struck us as being high, as we are more accustomed to seeing discounts range from between 10% to 20%. Perhaps this reflects a larger trend in convertible debt financings that will be revealed in future surveys.

The events that would trigger a conversion were reported as follows:



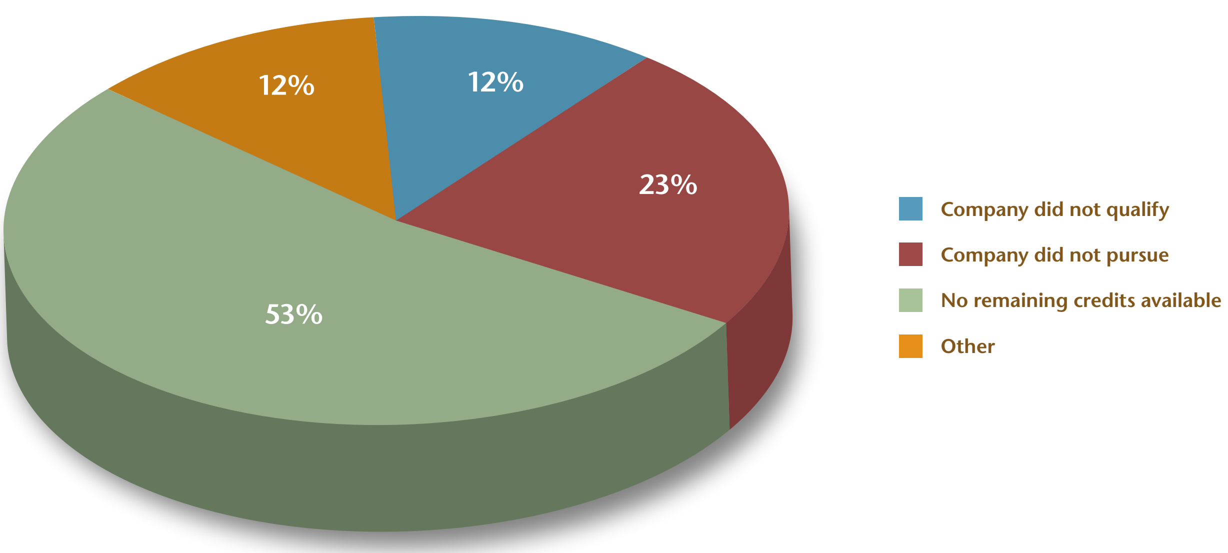
These percentages indicate that (consistent with our experience) most convertible debt can be automatically converted upon the occurrence of more than one triggering event.

For a triggering event based on the raising of future capital, 20% of respondents reported that the threshold amount was less than $1 million. No respondents indicated that the threshold amount was $1 million. 20% of respondents reported that the threshold amount was between $1 million and $2 million, and the remaining 60% reported that the threshold amount was greater than $2 million. These results were slightly different from the prior survey, when only 25% of respondents reported that the threshold amount was greater than $2 million. This could be the result of more respondents utilizing convertible debt as a bridge to larger rounds than in the past. We will continue to track this data as well to determine if the threshold amounts that trigger an automatic conversion are increasing.

MINNESOTA ANGEL TAX CREDIT

As with our prior survey, the questions regarding the Minnesota Angel Tax Credit had a high response rate. 79 of the 84 respondents (94%) answered these questions. Of those responding, nearly 71% noted that they utilized the Minnesota Angel Tax Credit in connection with their financing. Only 21% responded that they did not use the Minnesota Angel Tax Credit, with the remaining respondents indicating they were unsure if the Minnesota Angel Tax Credit was used.

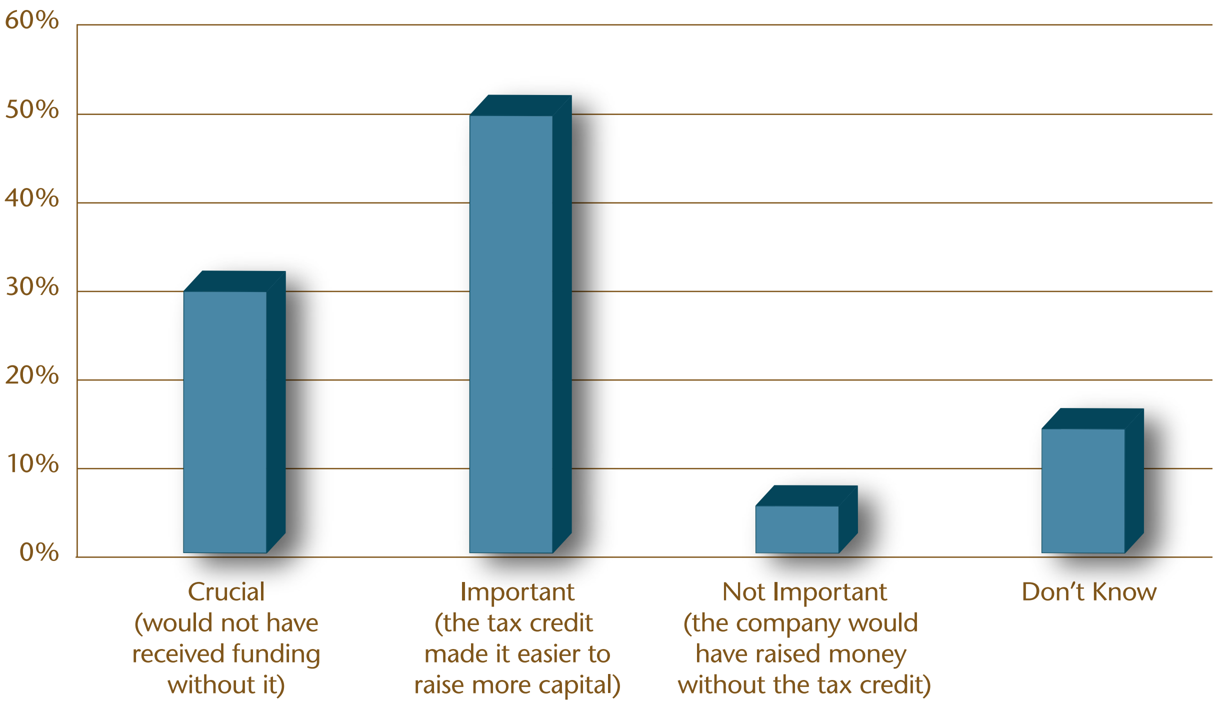
Of those who responded that they did not use the Minnesota Angel Tax Credit as part of the financing, the following were identified as the reasons:



As we suspected, a large percentage of those who did not use the Minnesota Angel Tax Credit were prevented from doing so due to lack of available credits. As many of you will recall, the $12.2 million of tax credits available for this year were initially exhausted in March of this year. $3 million of additional credits were made available in May, all of which were immediately applied for and allocated. As in prior years, there was much more demand for the Minnesota Angel Tax Credit than supply.

We suspect next year there will be similar tax credit shortage issues, as only $7.5 million of the available $15 million in credits will be made available to companies in the seven county metro area. The other $7.5 million in tax credits will be allocated to qualifying investments made in companies in the state's other counties, as well as for qualifying investments made in women-owned and minority-owned businesses. If those credits are not allocated by the end of September 2015, they will be available to qualified investments made in all other companies.

Of those who responded that they used the Minnesota Angel Tax Credit as part of the financing, over 80% indicated it was crucial or important. The following was the breakdown with respect to the importance of the Minnesota Angel Tax Credit in completing the financing:



Summary

With the few exceptions noted above, the results of this survey for the first half of 2014 are similar to those of the survey for the second half of 2013. As lawyers who are active in early stage capital raising transactions, we would have expected these results, as the climate for raising capital in Minnesota hasn't changed dramatically in the past 6 months. In some sense, these results validate the results of our prior survey.

In any case, we'll look for further validation (or contradiction) in our next survey, which we plan to release at the end of January 2015. At that time, we'll be requesting your responses regarding capital raising transactions that occurred during the second half of 2014. Your participation in that survey will be much appreciated.

We hope you enjoyed the second publication of the Seed Capital reVIEW.

Regards and happy capital raising!

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